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M&A: SHAPING THE FUTURE

'Biggest by a mile'

Megamergers' 1998 peaks signal trends for actuaries

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Among the thousands of words written about 1998's supermergers, perhaps this phrase from *Fortune's* Jan. 11 issue describes the year best: "biggest by a mile, according to any dollar-volume measure, against any other year, adjusted for anything, as a percentage of whatever you want."

Known in the headlines as "the year of the megamerger," 1998 brought deals totaling well over $1 trillion. (*The Economist's* aggregate price tag was $2.4 trillion in its Jan. 9 issue). And now-famous deals made the "mega" list individually, with the top spot going to Exxon and Mobil at $86 billion; Travelers Group and Citicorp ranked second at $73 billion. *Fortune* noted in its Jan. 11 story that eight of history's 10 biggest deals, and all seven of the largest, were made last year.

From helping negotiate deals to facing concerns about employment, actuaries are among those affected by the merger environment. Three executives, including one actuary, with a central view of "merger mania" addressed the topic in interviews for this article:

- Terry Lennon, executive vice president, Metropolitan Life Insurance Company, who launched MetLife's mergers and acquisition (M&A) department in 1994
- Salim Manzar, FSA, vice president and officer in charge of MetLife's M&A department
- Larry Mayewski, senior vice president of the insurance rating organization A.M. Best Co.

Why now?

What has pushed the merger machine into high gear? And why this point in time?

"A number of factors have fueled the acceleration of M&A activity," said Lennon at MetLife. "One is the need to drive down per-policy expense rates by increasing critical mass and eliminating redundant operations. A second is to add competencies or products to one's business portfolio. Another is the desire to find companies with complementary products and services so that you can cross-sell to each other's customers. The more products and services a customer has with a company, the more valuable that customer is."

Adding complementary capabilities to serve a growing market drove MetLife to merge with The New England Life Insurance Company in 1996. Lennon said, "The New England

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had built a solid reputation with affluent individuals and small business owners, while MetLife had built its business primarily in the middle-income market. In the flight to quality in the mid-'90s, MetLife's share of the upper income and small business market increased considerably. As a result, we had to decide between building or buying the structure to properly serve these markets in which The New England had the structure and expertise."

"In contrast," Lennon noted, "MetLife's acquisition of Banker's Trust's 401(k) business in 1997 added a competency to our business portfolio, in this case an administrative platform for large, complex 401(k) products."

Lennon sees another force giving rise to mergers. "Manufacturers and other companies have less control over pricing products and services than they once had," he said. He noted as an example that a security can be traded for as little as $9.95 today, while the lowest cost was at least 10 times that a few years ago. "Consumers are just not willing to pay more for products and services that are viewed as commodities. So consumers are unwittingly driving the merger environment in their quest for more competitive prices. Improvement in technology has increased capacity in many industries, allowing companies to drop prices as critical mass is obtained. Near term, consumers will benefit. Long term, however, it is harder to predict. There is some evidence that banking services are more expensive, if not more profitable, despite dramatic consolidation."

Fortune summed it up neatly: "Dozens of industries still carry heavy overcapacity; stocks are still strong; capital is still abundant and cheap," said the Jan. 11 article in predicting another gigantic wave of mergers this year. In "How to Merge: After the deal," in *The Economist's* Jan. 9 issue, the reporter pointed to two reasons why the big-ticket prices of 1998 won't hinder further mergers: fewer hostile takeovers and the replacement of stock swaps for cash. "In the 1980s, a quarter of all deals in America were hostile; this time, almost all have been agreed." Also, "where cash was once king, equity rules today...who can say which company is the more overvalued?"

Ego: the dark motivator

A number of observers see a less rational driver: the minds of executives overly focused on the power and glory of deal-making.

"We believe a number of insurance company deals resulted from the principals being caught up in the merger frenzy doing a deal just to do a deal," said Mayewski at A.M. Best. "This doesn't mean some of those mergers and acquisitions won't lead to economic success or that some companies involved won't be better off. It just leads the rating agencies to take a 'wait-and-see' attitude with some of these deals rather than jumping on the bandwagon."

Another Jan. 9 story in *The Economist*, "How to Make Mergers Work," shined a more detailed light on the topic. "However wrapped up in sonorous stuff about synergy, plenty of mergers begin with sheer executive boredom," the editors said. Running a company, especially in a mature market, "can be dull" compared to the wild attention paid by investment bankers and the media when a merger is pursued. The editors also said many executives were overly influenced by "the fear of looking foolish or being left behind. All too many boards are carried away by a terror that they will be bought before they can buy."

Roll up the sleeves

As the pre-deal excitement fades, company leaders face the massive chore of making one company out of two, noted several observers.

Looking at the massive Travelers / Citicorp merger, Mayewski mentioned several post-deal considerations:

- Company leaders need "to meld two distinct cultures."
- Can managers properly execute cross-selling? "The deal has clout, size — but you still have to execute."
- Consumers will remain price conscious. "Customers will seek value, and that consideration could outweigh their desire to do business with one company or enterprise."

The article "How to Merge: After the deal" in the Jan. 9 *Economist* discussed elements of post-merger challenges. These massive functions include melding two giant companies' information technology systems, dealing with antitrust issues, and blending corporate cultures. While "culture" is often called a "soft issue," its impact is great and complex, the article said, noting intangible assets such as webs of relationships with suppliers and the difficulties of merging companies from different countries.

Forecasting success

Mayewski said recent studies have shown 60-70% of mergers and acquisitions are considered failures when measured by an organization's performance relative to stockholder expectations or peer company results.

With observers everywhere predicting more deals, what will financial experts look for in megamergers of the future? Mayewski outlined the issues evaluated by A.M. Best in assessing deals:

a) Is there an economic and / or strategic fit?

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b) Does management have a strategy to deal with cultural and operational conflicts?
c) Are there objective goals and clear timelines?
d) Have areas of integration (synergies) been identified?
e) Have expense savings been identified and quantified?
f) Are top executives and managers communicating well? The people issues are often overlooked. All individuals involved should know what the deal’s goals are. It’s the people who make the deal successful.
g) Does the deal address an important business issue?
h) Does the deal’s success hinge solely on the creation of synergies?
i) Will the new mega-company add value to its customers and, ultimately, its shareholders? In successful transactions, adding value is critical. Some transactions look successful through accounting procedures, but long-term, will true economic value be created?

Cross-selling, a business issue raised in many mergers, is vital yet difficult to attain. Best’s raters, said Mayewski, “have seen very few successful stories with cross-selling.” Commenting on the Travelers / Citicorp merger, he said, “They’ll clearly have to sell more products, ratchet up their cross-selling for the deal to be successful, to justify the cost of the transaction.” Said Manzar at MetLife of the same merger, “Never before have we seen this level of commitment to the cross-sell opportunity, but having said that, the jury is still out on whether the effort will succeed. It’s an interesting transaction to keep an eye on.”

Deals often are heralded as beneficial for stockholders and policyholders. Mayewski and others believe that isn’t always the case, but it should be the focus, and the focus should be long term. About insurer deals, he said, “We believe that strengthening the organization overall — doing the right thing — will benefit stockholders and policyholders. We believe the interests of stockholders, policyholders, and distribution all have to be in line.”

Changing the world

Industries with a strong impact on actuaries — banking and insurance — are seeing changes as a result of mergers, observers said. The biggest, of course, is that the industries themselves are merging as banks and insurers merge with one another.

“The transformation of the financial services industry is signaled by transactions on the scale of Travelers / Citicorp,” Mayewski said. “Banks and insurers are all fighting for the same customer long term, and many companies are seeking a currency and capital to increase their financial flexibility to be better positioned to do deals.” Like Lennon, Mayewski sees consumers driving many of the changes in the financial industry. “Banks and insurers recognize that the consumer, long term, will call the shots on product and distribution and how much advice they’ll want. If a consumer wants to work through a broker, then having brokerage service will help. If the consumer wants advice through the traditional agent channel, then having that is important. So companies believe they have to offer a broad array of services through a larger number of distribution points.” Lennon said much the same thing in discussing one of two principal reasons behind the increase in M&A initiatives: “acquiring businesses with complementary products and services” (the other reason is expense savings).

But megamergers raise questions well beyond individual industries.

Said Mayewski, “When you look at Travelers / Citicorp, clearly it’s a watershed transaction. These enormous deals will force Washington to face the changes in the financial services environment, the whole regulatory structure, and this will have an impact on all financial services companies, not just insurers and banks.”

In a Jan. 25 *Business Week* article, “Megamergers are a clear and present danger,” Yale School of Management Dean Jeffrey E. Garten goes even farther. He noted, “The big problem with these gigantic mergers is the growing imbalance between public and private power in our society.” Megacompanies won’t support local areas’ education, arts, or research, but the companies’ sheer size will allow them heavy influence on public programs, both domestic (such as social security programs) and international, as well as on environmental practices.”

The art of the deal needs actuarial skills

Megamergers’ impact may be immense and hard to manage, but that level of difficulty may be second only to that of valuing a mega-deal in the first place, experts say. A story from June 25, 1998, posted on CNN’s Web site in January quoted a spokesperson from the Financial Accounting Standards Board: “...deal-value computing is ‘not really an accounting issue’ but rather one best left to the companies and their financial advisers to hammer out.” The spokesperson also said of due dilligence, “It’s an art. There are no rules about what to do.”

All three executives interviewed for this story agree that actuaries should be one of the crucial professionals at the negotiating table.

Manzar at MetLife said, “In negotiation, actuaries have a distinct advantage in assessing the implications of a change to the structure of a transaction or how a change in price will impact the overall value of a deal. Actuaries develop, underwrite, and price products and services and, therefore, understand the risks and values inherent in the business." Lennon, the executive officer who promoted actuary Manzar to the top M&A post at MetLife, obviously agrees. "The life insurance business is more complex than most people realize," he noted. "Just one example — the relationship between the left and right sides of a life insurance company's balance sheet is unique. Actuaries understand this relationship and its intricacies. A successful M&A transaction depends on a real understanding of these types of relationships and the assumptions used to determine value and price."

While many actuaries aren't ready to sit at a negotiating table, most experts agree they could develop the capabilities they need more easily than other professionals.

Actuaries need to be more proactive, Mayewski said. "They should play an increased role in checks and balances. 'Are we comfortable with the values, the assumptions embedded in the pricing?' And, if not, they must step up to the table and speak out when the long-term economic value is not there."

Said Mayewski, "What M&A all comes down to is quantification of value. Who better than actuaries to play a key role in reviewing the underlying assumptions of a deal?" Insurance transactions especially require actuaries' knowledge, he said. "They're in the best position to review the underlying value of business assumptions and model their performance under different scenarios."

Said Manzar, "The actuarial education program should be viewed as providing a set of tools and insights to becoming a better all-around business person. These tools and insights are an advantage; they give us an edge others don't have.

"Actuaries seldom reap all the benefits their edge provides. They do things like modeling, which is important, but technical. I feel actuaries have more to offer than technical competency and should take the next step. In the M&A field, for example, our training is ideal for devising creative solutions in structuring the deal and being the lead business person (not technician) at the negotiating table."

Noted Lennon, "The opportunity for the actuary is to use his or her technical knowledge to become a better business person. To understand the financial implications of what the other side is proposing is tremendously valuable in negotiation. When actuaries combine business sense with their technical skills and knowledge, they truly have an advantage."

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Academy actuary steps in for U.S. president at Social Security event

by Kelly Mayo
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What does the White House do when they need a replacement for U.S. President Bill Clinton? They call Ron Gebhardtsbauer, senior pension fellow for the American Academy of Actuaries.

Gebhardtsbauer had been invited to speak at the high-profile White House Conference on Social Security last December. The conference would bring together leading lawmakers and Social Security experts to discuss the future of the nation's largest retirement income program.

The evening before the conference, the White House placed a call to Gebhardtsbauer's home. It seemed that Clinton, who was to be a central figure all morning, would have to leave right after his opening speech to attend the funeral of U.S. Sen. Albert Gore, father of Vice President Al Gore. The White House asked Gebhardtsbauer if he could fill in for the president and moderate the morning session. "It didn't take me long to say 'Yes!'" recalled Gebhardtsbauer.

At the conference, Gebhardtsbauer moderated a one-and-a-half-hour discussion that was carried live on the nationwide C-SPAN 2 network. "I've done a lot of public speaking over the past two years at Town Hall forums, so I wasn't nervous at all. I introduced the session and the speakers and asked them their first questions. Then I walked into the audience, which consisted of about 250 people, and got to play 'Phil Donahue,'" said Gebhardtsbauer.

Attendees at the event included actuaries Robert J. Myers, former chief actuary of the U.S. Social Security Administration, and Stephen Kellison, public trustee of the Social Security Trust Funds; former presidential candidate Jesse Jackson; AFL-CIO chief John Sweeney; National Organization for Women President Patricia Ireland; and 40 members of the U.S. Congress.